

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
ESTATE OF DONALD DURHAM, DECEASED,)
MARGARET M. DURHAM, EXECUTRIX)

For Appellant: Edward O. Robinson
Attorney at Law

For Respondent: Bruce W. Walker
Chief Counsel

John A. Stilwell, Jr.
Counsel

OPINION

This appeal is made pursuant to section 19059 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of the Estate of Donald Durham, Deceased, Margaret M. Durham, Executrix, for refund of personal income tax in the amount of \$451.00 for the year 1968.

We are asked to decide whether a resident of this state should be allowed a credit against California income tax, for taxes paid to a sister state on dividends received from a

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business incorporated in that state, where the corporation has elected under subchapter S of the Internal Revenue Code and a like foreign state statute to be taxed similarly to a partnership.

The Donald Durham Company, Inc. , is an Iowa corporation doing business solely in Iowa. During the year in question its stock was owned by three shareholders who had elected to be taxed under the provisions of subchapter S of the Internal Revenue Code, sections 1371 through 1377. By virtue of these provisions the company was essentially relieved of federal income tax liability, and the corporate income was taxed instead directly to the shareholders. The election was also effective in Iowa pursuant to Iowa Code section 422.36(5), which states:

Where a corporation is not subject to income tax and the stockholders of such corporation are taxed on the corporation's income under the provisions of the Internal Revenue Code of 1954, the same tax treatment shall apply to such corporation and such stockholders for Iowa income tax purposes.

Margaret Durham, a California resident, held 100 shares in the company as executrix of the estate of Donald Durham, and she reported on her California fiduciary income tax return that the shares earned \$14,920 for the estate in 1968. Taxes were paid on that amount to California, but not to Iowa. In 1971, however, the Iowa Supreme Court decided in Isaacson v. Iowa State Tax Commission, 183 N. W. 2d 693, that nonresident stockholders of an Iowa corporation which had made a subchapter S election must pay Iowa income tax on dividends from the corporation. Pursuant to this decision, the Iowa State Tax Commission notified Mrs. Durham of a claimed deficiency of \$451 for 1968. After paying this deficiency Mrs. Durham filed a claim for refund in that amount with the California Franchise Tax Board, asserting that the tax paid to Iowa should be allowed as a credit against the estate's 1968 California tax. Respondent denied the claim, giving rise to this appeal.

Subject to certain conditions, Revenue and Taxation Code section 18001 allows a credit to California residents^{1/} for net income

^{1/} The estate in this case is considered a "resident" for purposes of section 18001. (Rev. & Tax. Code, § 18003.)

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taxes paid to another state on income also taxable in California. One of those conditions is set forth in subdivision (a) of that section, which provides:

(a) The credit shall be allowed only for taxes paid to the other state on income derived from sources within that state which is taxable under its laws irrespective of the residence or domicile of the recipient.

For the purposes of this appeal, the critical language is "income derived from sources within that state, " because respondent's denial of the tax credit was based on its determination that the dividend income in question was derived from a source within California rather than Iowa. In making that determination, respondent applied the well established California rule that the "source" of dividend income is the stock itself, which has -a taxable situs or location at the domicile or residence of the owner, absent special circumstances not present here. (Miller v. McColgan, 17 Cal. 2d 432 [110 P. 2d 419]; Safeway Stores, Inc., v. Franchise Tax Board, 3 Cal. 3d 745 [91 Cal. Rptr. 616, 478 P. 2d 48].)

Appellant has no quarrel with this rule, but argues that it should not apply to the facts of this case. Because of the subchapter S election, it contends, the Donald Durham Company, Inc. , "is a partnership" so far as Iowa and the federal government are concerned, and California should therefore determine the source of income received from the company by the rules applicable to income from partnerships. We have considered this argument in several previous cases, however, and held that a corporation which elects to be taxed under subchapter S or a like state statute, while taxed in many respects similarly to a partnership, remains a corporation for California tax purposes. (Appeals of David W. and Marion Burke, et al. , Cal. St. Bd. of Equal., Oct. 27, 1964; Appeal of John K. and Patricia J. Withers, Cal. St. Bd. of Equal. , Sept. 1, 1966 Appeal of Theo and Audrey Christman, Cal. St. Bd. of Equal., Dec. 11, 1973.)

Appellant also contends that since the tax credit provision of section 18001 is intended to prevent double taxation, it is arbitrary to adopt a policy toward subchapter S corporations which defeats this purpose. However, despite the substantial similarities in other respects between federal income tax law and both the California

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Personal Income Tax Law and the Bank and Corporation Tax Law; the Legislature has never adopted a California counterpart of subchapter S. That indicates to us a legislative intent that, for California tax purposes, subchapter S corporations and their shareholders are to be treated no differently than all other corporations and shareholders. Furthermore, section 18001 in effect authorizes an exemption from an otherwise valid tax, and as such it must be strictly construed against the taxpayer. (Miller v. McColgan, supra, 17 Cal. 2d at 441-442.) To treat the corporation as a partnership, creating a legal fiction solely to aid appellant's claim for exemption, would run counter to this well settled rule. (See Laurel Hill Cemetery Association v. City and County of San Francisco, 81 Cal. App. 2d 371, 376 [184 P. 2d 160].)

The source of the income received by the estate from the Donald Durham Company, Inc. , must therefore be determined by the general rule for corporate dividends. Since under this rule the income was received from a source within California, the credit claimed for taxes paid thereon to Iowa was properly disallowed. (Appeal of John K. and Patricia J. Withers, supra; Appeal of Theo and Audrey Christman, supra.)

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

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IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim for refund of the Estate of Donald Durham, Deceased, Margaret M. Durham, Executrix, for refund of personal income tax in the amount of \$451.00 for the year 1968, be and the same is hereby sustained.

Done at Sacramento, California, this 12th day of November, 1974, by the State Board of Equalization.

_____, Chairman
John W. Lynch, Member
Robert Spence, Member
Shelley for Burnett, Member
Robert Stein, Member

ATTEST: *W.W. Dunlop*, Secretary